Supreme Court, U.S.
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No. 02-1779

IN THE

Supreme Court of the United States

GREG SEINFELD,

Petitioner,

v.

CAROL A. BARTZ; JOHN T. CHAMBERS; MARY A. CIRILLO; JAMES F. GIBBONS; EDWARD R. KOZEL; JAMES C. MORGAN; JOHN P. MORGRIDGE; ARUN SARIN; DONALD T. VALENTINE; STEVEN M. WEST; and CISCO SYSTEMS, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF

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I. THE QUESTION IS IMPORTANT

The Respondents are unable to deny the critical economic importance to societal well being of institutional and individual holdings of corporate stock and the frequent and substantial effects on that wealth that result from stockholders' votes on stock option plans. The Respondents are unable to deny or to refute Chairman Greenspan's affirmations of the importance of disclosing the value of stock options.

The Question Presented addresses "a problem beyond the academic or episodic," (*Rice v. Sioux City Memorial Park Cemetery*, 349 U.S. 70, 74 (1955)) and presents "compelling reasons" for granting this petition. (Supreme Court Rule 10). It is not remotely, let alone "entirely hypothetical." *Ticor Title Insurance Co. v. Brown*, 511 U.S. 117, 118 (1994).

II. THE QUESTION SHOULD BE SETTLED BY THIS COURT

The Respondents make the demonstrably false statement that the Question Presented is the subject of "an ongoing debate among financial professionals, companies and regulators about arcane matters of accounting and economic modelling." (Resp. at 6.) In fact, there is no debate in that arena about Black-Scholes disclosures at the time of stockholder approval of stock options and plans to grant them, but only the question of how to report the expensing of those stock options after they are approved and granted. (Pet. at 6, 8.) There is no debate about the efficacy of the Black-Scholes model or similar binomial models to evaluate corporate stock options for directors, officers and employees,

at least among the informed. The only source of objection is from option holders who prefer that the public be ignorant of the amounts involved.

Moreover, we cannot expect that Congress or the SEC will address the Question Presented (Resp. at 13), for they have already done that. Accordingly, Supreme Court review of the Question Presented is necessary in order to correct repeated errors in the lower courts concerning the statutory and regulatory requirement that stock option values be disclosed when stockholder approval is sought, i.e., when disclosure will do the most good, and that values be determined according to the Nobel Prize winning Black-Scholes model or some equally good binomial model, as prescribed by the Financial Accounting Standard Board, whose function is approved by the Securities and Exchange Commission.

The Ninth Circuit made frequent disparaging comments about Black-Scholes, notwithstanding the Respondents' protestations to the contrary. (Resp. at 6.) That court at 7a noted that the stock warrants in its decision *Custom Chrome, Inc. v. Comm.*, 217 F.3d 1117, 1120 (9th Cir. 2000) were "in essence, options," which could be evaluated by Black-Scholes, but it then said:

> *Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors, and it certainly does not require the use of Black-Scholes to value options for purposes of a proxy statement. Its reasoning simply is inapposite to the issue presented here.

The Ninth Circuit did not explore whether, apart from *Custom Chrome*, Black-Scholes would work on the stock options at bar.

Although FASB 123 endorses Black-Scholes for the kind of stock options at bar, the Ninth Circuit held, without a record of expert testimony, that FASB 123 applied to financial statements, not proxy statements. Again, the Ninth Circuit did not explore whether, apart from FASB 123, Black-Scholes would work, nor did it explain why the presentation of financial information, i.e., a proposed issue of stock options, which if approved would appear on future financial statements, was not in and of itself a financial statement. *Matter of Trump Hotels & Casino Resorts, Inc.*, 2002 WL 58566 (SEC Rel. No. 34-45287, January 16, 2002).

Finally, the Ninth Circuit (9a-10a) rejected FASB 123's conclusion that it is wrong (or, as Chairman Greenspan said, "flat wrong," *The Wall Street Journal*, p.C-3, May 9, 2003) to say that a stock option has no value unless there is a price increase in the underlying stock. The court (11a) went on to quote *Resnik v. Swartz*, 303 F.3d 147, 154 (2nd Cir. 2002) to say it "accurately describes how value is realized when options are actually exercised." Even the "actually exercised" language is wrong, for it overlooks the time value of deferring the time to pay the purchase price. Ciesielski, Editorial Commentary, "Another Options War", *Barron's* p.39 (May 5, 2003) 2003 WL-BARRONS 6977368. Even underwater stock options have value that can be extracted without exercising them, as shown by the recent events at Microsoft Corporation, a Washington corporation, covered extensively in *The Wall Street Journal* on July 9 and 10, 2003. Published before the Microsoft story, it was noted in the

Harvard Business Review that senior executives might "have enough at stake to contract with an investment bank to hedge their option positions without exercising prematurely." Bodie, Kaplan, Merton, "For The Last Time: Stock Options Are An Expense," *Harv. Bus. Rev.*, 2003 WL 9953511, in the segment "The Real Impact Of Forfeiture and Early Exercise" (March 1, 2003). It is true that one court compared such a hedge to gambling "at a racetrack" and keeping money on a hot stock to money in the bank. *In re 3Com Corp. Sh.Lit.*, 1999 WL 1009210 at *8 (Del.Ch. 1999). But that was in the heady time of October 1999, shortly before the bubble burst, and many billions of dollars were lost. The *3Com* court was one that took "a rather jaundiced view of . . . [Black-Scholes] valuations and their reliability." (at *4 n.7).

The Respondents attempt to justify the Ninth Circuit's narrow focus on Items 402(c) and (g) of 17 C.F.R. § 229. They contend that Item 10 of 17 C.F.R. § 240.14a-101 was properly unmentioned since it does not refer to "Black-Scholes or any other option pricing model." (Resp. at 10 n.2.) However, the Item 10 Table, reproduced at 30a, does require a report of the "Dollar value ($)" of the non-cash benefits. To report a dollar value of a stock option "requires using the Black-Scholes formula." Thomas and Martin, *The Determinants Of Shareholder Voting On Stock Option Plans*, 35 Wake Forest L.Rev. 31, 41 (2000). Moreover, it requires a disclosure of the dollar value of the proposed new benefits as if they had been in place the previous year if not determinable in the current year (17 C.F.R. 240.14a-101 (Item 10)(a)(2)(iii)(C)) reproduced at 31a (not 32a as erroneously stated at Pet. at 3). This provision of Item 10 eliminates the need for the distinction drawn below (7a-8a), between disclosure in a proxy statement and a year end financial statement. *See* Resp. at 11.

Respondents' repeated assertions that stock options cannot be valued, that Black-Scholes does not work (Resp. at 12 n.3), and their repeated, pejorative, epithetic term "theoretical" when referring to dollar valuations obtained by Black-Scholes are so hopelessly unscientific that there is no evidence for them that a court could admit under prevailing standards, e.g. *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999). "This Court has refused to accept assumptions of fact that are demonstrably false," no matter who agrees to it. *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 497 (1951). These assertions underscore our point that this important issue should be settled by the Supreme Court.

The need for the settlement by the Supreme Court of the Question Presented is based upon the total rejection by the lower courts of the legal standards concerning principles of economic science and accounting that are universally accepted by thoughtful, respected, disinterested authorities, e.g., the Financial Accounting Standard board, Chairman Alan Greenspan, the Securities and Exchange Commission, the Internal Revenue Service (in Rev. Rul. 98-21 and Rev. Proc. 98-34), and the world's financial markets (Chriss, *Black-Scholes and Beyond: Options Pricing Models*, (Irwin 1997), E5-7, 74). The Ninth Circuit did not simply make erroneous factual findings and misapply a properly stated rule of law. Rather, it failed to identify the correct rule of law. *Universal Camera Corp. v. NLRB*, *supra*, 340 U.S. at 491. By so doing, it has seriously compromised the efforts of the Financial Accounting Standards Board (with Chairman Greenspan's warm concurrence) to provide at least some important relief from the recent excesses cast upon our financial markets and our entire societal well being by false accounting. Accounting may be a dull subject and economics a dismal science, but if they are mishandled, they can wreak havoc.

Corporations are managed by boards of directors. Stockholders do not have much say. They elect directors, usually without a choice of candidates, and so with little effect. They vote on mergers and liquidation, which are rare events, and they vote on stock option plans, fairly frequently and with substantial economic consequences.

III. THIS IS A GOOD CASE TO SETTLE THE QUESTION

The facts at bar are good for settling the Question Presented. They include a proposal in which the board is interested, and the Proxy Statement dramatically understates the dollar value of the board members' annual compensation. It would have been painfully simple for the Respondents to have disclosed the previously calculated Black-Scholes value of the stock options granted in the previous year to the non-employee directors as if the Amendment had then been in effect and thereby have complied with 17 C.F.R. § 240.14a-101 (Item 10)(a)(2)(iii). *See*, Appendix at 31a.

The legal analysis of the lower court also makes this a good case for settling the Question Presented. It overlooked the statutory purpose to insure honest securities markets through full disclosure, and it construed the statute technically, restrictively, and narrowly, rather than flexibly, as required. *SEC v. Zandford*, 535 U.S. 813, 819-11 (2002).

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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